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No.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

**DEPARTMENT OF REVENUE,
STATE OF ILLINOIS, et al.,**

Petitioners,

v.

**CONTINENTAL ILLINOIS NATIONAL BANK
AND TRUST COMPANY, et al.,**

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF ILLINOIS

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QUESTION PRESENTED FOR REVIEW

Does 31 U.S.C. § 742, as amended, require a state to not only deduct interest on United States obligations from the tax base but also to exclude it from an apportionment formula which distributes that tax base among jurisdictions?

PARTIES TO THE PROCEEDINGS

Department of Revenue, State of Illinois;

Daniel J. Lenckos, as Acting Director of the Illinois Department of Revenue; and

Donald R. Smith, as Treasurer of the State of Illinois,

Petitioners,

Continental Illinois National Bank and Trust Company of Chicago;

Continental Illinois Corporation;

Continental Illinois Leasing Corporation;

Marina City Building Corporation;

Cobak Corporation;

Continental Illinois (Delaware) Limited;

Continental Illinois Overseas Service Corporation; and

Continental Illinois Service Corporation,

Respondents.

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In The

Supreme Court of the United States

October Term, 1984

DEPARTMENT OF REVENUE, STATE OF ILLINOIS, et al.,

Petitioners,

v.

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF ILLINOIS

OPINIONS BELOW

The opinion of the Illinois Supreme Court is reported in 102 Ill. 2d 210, and it appears in Appendix A. The opinion of the Appellate Court, First District, State of Illinois is reported in 115 Ill. App. 3d 538, and it appears in Appendix B. The order of the Circuit Court of Cook County is unpublished, and it appears in Appendix C. The judgment of the Illinois Supreme Court appears in Appendix D.

JURISDICTION

The judgment of the Illinois Supreme Court was filed on May 25, 1984, and an order which stayed the mandate pending the filing and outcome of this petition was entered June 29, 1984. This petition is being filed within ninety days of that judgment.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(3).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

United States Constitution

Article I, Section 8, Clause 2 – Borrowing Clause

The Congress shall have Power . . . to borrow money on the credit of the United States. . . .

Article VI, Clause 2 – Supremacy Clause

This Constitution, and the Law of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Federal Statute

31 U.S.C. § 742 — Exemption from taxation

Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

State Statute

Ill. Rev. Stat. 1975, ch. 120, sec. 3-304(c)(3)

"(c) Financial organizations. Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State, and the denominator of which is its business income from all sources. For the purpose of this subsection, the business income of a financial organization from sources within this State is the sum of:

* * *

(3) Interest and dividends received within this State;"

STATEMENT OF THE CASE

Continental Illinois National Bank and Trust Company of Chicago, et al. (the "Bank") received interest income from obligations issued by the United States. The Bank deducted this interest in determining its income tax base, and it excluded this interest from the apportionment fraction used to determine the portion of its income tax base which is taxable in Illinois. The Illinois Department of Revenue (the "Department") agreed that interest on U.S. obligations should be deducted in determining the tax base. However, it disagreed with the exclusion of the interest from the apportionment fraction, and it notified the Bank of tax deficiencies for 1973, 1974 and 1975 in the amounts of $12,175, $22,714, and $60,694, respectively. The Bank paid these and other monies under protest.

The Circuit Court of Cook County rendered a decision on three issues, one of which is the subject of this petition. That Court held, in relevant part, that since "(t)he State of Illinois does not have the constitutional power to tax interest on obligations of the United States," that interest cannot be used in a formula the purpose of which is to determine the amount of taxable income apportionable to the state. Appendix C-7.

The Appellate Court, First District, also rendered a decision on three issues. In the relevant portion of its opinion, it considered whether either 31 U.S.C. § 742 or the borrowing clause (U.S. Const., art. I, sec. 8) or the supremacy clause (U.S. Const., art. VI) of the United States Constitution, placed a limitation on the Illinois statutory provisions regarding the apportionment of income. The Court indicated that while it was somewhat

inclined to accept the Department's position, it decided to follow *Federal Products Corp. v. Norberg*, 429 A. 2d 447 (R.I. 1981). Appendix B-7 to B-9.

The Supreme Court of Illinois decided two issues, one of which is the subject of this petition. After considering the Department's federal statutory and constitutional arguments, that Court stated "We do find that it is possible to apply the [Illinois] apportionment formula without running afoul of the supremacy clause of the United States Constitution (art. VI, cl. 2) as well as article I, section 8, which provides Congress with the power "[t]o borrow money on the credit of the United States." U.S. Const., art. I, sec. 8, cl. 2." Appendix A-13.

However, that Court also found that the 1959 amendment to 31 U.S.C. § 742 emphasized that the statutory limitation on state taxation was absolute. It concluded "[O]n the basis of the relevant federal statute (31 U.S.C. § 742 (1969)) and the recent decision of the Supreme Court in *American Bank & Trust Co. v. Dallas County* (1983), 463 U.S. __, 77 L. Ed. 2d 1072, 103 S. Ct. 3369, that tax-exempt interest income on obligations of the United States may not be taken into consideration in apportioning taxable income." Appendix A-14.

REASONS FOR GRANTING CERTIORARI

A.

THE STATE COURT'S INTERPRETATION OF 31 U.S.C. § 742 IS NOT CONSISTENT WITH THE APPLICABLE CASE LAW OR CONSTITUTIONAL PROVISIONS.

The state court's decision raises an important federal question because its interpretation of 31 U.S.C. § 742 is more restrictive than the limitation placed on state taxation by the Borrowing and Supremacy Clauses of the United States Constitution. U.S. Const., Art. I, sec. 8, cl. 2 and Art. VI, cl. 2.

The Illinois Supreme Court expressly found "(T)hat it is possible to apply the (Illinois) apportionment formula without running afoul of (either the Borrowing or Supremacy Clauses)." Appendix A-13. Yet the Court went on to find that the federal statute did place a limitation on the Illinois apportionment formula.

In *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, __, 103 S. Ct. 692, 696 (1983), this Court observed that "Our decisions have treated § 742 as principally a restatement of the constitutional rule. See, e.g. *New Jersey Realty Title Ins. Co. v. Division of Tax Appeals*, 338 U.S. 665, 672 (1950); *Missouri Ins. Co. v. Gehner*, 281 U.S. 313, 321-322 (1930)." And, in *Society for Savingss v. Bowers*, 349 U.S. 143 (1955), this Court stated that the immunity of federal obligations from state taxation was derived from the Borrowing and Supremacy Clauses of the Constitution; it was the basis of several landmark decisions; and "(i)t was subsequently embodied in a succession of federal statutes, the existing statute being R.S. § 3701, 31 U.S.C. § 742." 349 U.S. at 144.

Since this Court has so frequently viewed 31 U.S.C. § 742 as a restatement or embodiment of constitutional principles, it should not allow a state court to deviate from that interpretation.

The state court should not have decided that the federal statute placed an absolute prohibition against consideration of tax-exempt interest for state tax purposes. In 1959, the statutory exemption of U.S. obligations from state taxation, 31 U.S.C. § 742, was amended to show that it applied

> ". . . to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax (subject to certain exceptions)." Act of Sept. 22, 1959, § 105(a), 73 Stat. 622.[1]

The purpose of this amendment was to eliminate the economically meaningless distinction between taxes on United States obligations and taxes on separate interests or transactions whose value included those obligations. *American Bank & Trust Co. v. Dallas County*, 463 U.S. __, 103 S. Ct. 3369 (1983).

Prior to 1969, the federal statute prohibited a state tax imposed on United States obligations, but it did not prohibit other forms of taxation where the value of the interest or transaction subject to tax included the value of United States obligations. This meant that numerous forms of taxation, such as bank shares, corporate franchise, and inheritance, could include the value of United

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[1] This statute was revised and recodified as 31 U.S.C. § 3124 pursuant to Public Law 97-258 (September 13, 1982). Although the revision and recodification made no substantive change in the law, it is noteworthy that the words "directly or indirectly" were omitted as surplus. H.R. Rep. No. 97-651 at 94.

States obligations. The 1959 amendment abolished this distinction except for a few forms of taxation.

The Illinois Supreme Court's discussion of *American Bank & Trust Co.* was limited to that Court's application of the 1959 amendment to a bank shares tax. It overlooked the Court's careful analysis of the case law prior to 1959 and the legislative history. As a result, the state court did not consider either the difference between an apportioned income tax and a bank shares tax or how 31 U.S.C. § 742, as amended, should be applied to the former.

When a corporation derives income from two or more states, it becomes necessary to determine the portion of income which may be taxed by a particular state. In Illinois, income is apportioned according to business activity, and the business activity of a bank is measured by a one factor "gross receipts" formula. Ill. Rev. Stat. 1973, ch. 120, sec. 3-304(c). The numerator of this fraction includes all interest received in Illinois, and the denominator includes all interest received everywhere.

There are several reasons why the literal language of the 1959 amendment does not place a limitation on amounts included in the Illinois "gross receipts" apportionment formula. First, an apportionment formula is not a form of taxation; it is a method of distributing a fixed tax base among the jurisdictions in which a business operates. As the Illinois Appellate Court observed "Apportionment does not increase or decrease the tax base (total taxable income); it determines what portion of that income was earned in each of the States in which a taxpayer transacts business." Appendix B-3 to B-4. The purpose of the 1959 amendment was to make sure that United States obligations and the interest thereon were not included in the tax base regardless of the form of taxation.

The amendment was not aimed at the method of distributing that tax base among jurisdictions.

Secondly, while interest on United States obligations is considered in the computation of business activities, it is not considered in the computation of the tax. The computation of business activities and the computation of tax are two separate and distinct calculations. Each serves a different purpose and each is comprised of different elements.

The percentage of business activities within a State is used to determine the portion of the tax base which may be taxed in that State. Under Illinois law, a bank's gross receipts are used as the measure of its business activities. All interest, including tax-exempt interest, should be included in that measure in order to determine where the bank conducts its business. Interest is used in this computation as an indicia of business activity, not as an element of income, and it should be viewed as a substitute for property, payroll and sales which are the components of the commonly used three factor apportionment formula.

The Illinois income tax is computed by multiplying the tax rate by net income. Ill. Rev. Stat. 1973, ch. 120, § 2-201. Interest on United States obligations is not included in net income. Ill. Rev. Stat. 1973, ch. 120, § 2-203(b)(2)(G). Thus, the tax-exempt interest is not considered in the computation of the tax.

Thirdly, the federal statute is not an absolute prohibition against consideration of federal obligations for all state tax calculations. Even the Bank considered them when it deducted tax-exempt interest in arriving at its tax base.

Finally, the 1959 amendment should be read in a way which furthers the purpose of the original statute. As was

indicated in *Society for Savings v. Bowers*, 349 U.S. 143, 144 (1954), that purpose is to protect the borrowing power of the United States from state encroachment. As the Illinois Supreme Court found, the apportionment of income by formula does not place a burden on the United States or its obligations.

B.

THE STATE COURT'S DECISION IS IN CONFLICT WITH THE DECISION OF ANOTHER STATE COURT ON A RELATED ISSUE.

Bartow County Bank v. Bartow County Board of Tax Assessors, et al., 251 Ga. 831, 312 S.E.2d 102 (1984), *prob. juris. noted sub nom. First National Bank of Atlanta, etc. v. Bartow County Board of Tax Assessors, et al.*, __ U.S. __ , No. 83-1620 involves a state tax on bank shares, and the Georgia Supreme Court upheld the proportionate deduction method of valuing a bank's net worth. In so doing, the Court found that 31 U.S.C. § 742 addresses itself to the exclusion of federal obligations from the tax base and that it is not an absolute prohibition against all consideration of those obligations for state tax purposes.

The Georgia Supreme Court was not faced with precisely the same issue as is the subject of this petition because, in this case, tax-exempt interest has been deducted in full in arriving at the Illinois income tax base. However, that Court did approve of the consideration of tax exempt obligations in order to determine the proportion of those obligations which should be deducted in arriving at the tax base. In contrast, the Illinois Supreme Court did not approve of the consideration of tax-exempt interest in the apportionment of a share of the tax base to Illinois. This represents a conflict among state courts over whether the value of United States obligations may ever be considered for state tax purposes.

If this Court, in Docket No. 83-1620, affirms the decision of the Georgia Supreme Court, then it should reverse the judgment of the Illinois Supreme Court.

It should be pointed out that the Illinois Court's decision is consistent with *Federal Products Corp. v. Norberg*, 429 A. 2d 447 (R.I. 1981), and the two cases involved identical issues. However, for the reasons stated in Part A of this petition and others, these cases were decided incorrectly.

CONCLUSION

For the foregoing reasons, a Writ of Certiorari should be granted to review the judgment and opinion of the Supreme Court of Illinois.

Respectfully submitted,

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August 23, 1984

APPENDIX A

IN THE
SUPREME COURT OF ILLINOIS
FILED MAY 25, 1984

Docket Nos. 58876, 58881 cons.—Agenda 17—March 1984.
CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO *et al.*, Appellants, v. DANIEL J. LENCKOS, Acting Director of Revenue, *et al.*, Appellees.

JUSTICE MORAN delivered the opinion of the court:

Plaintiffs, Continental Illinois National Bank and Trust Company of Chicago (the bank) and seven of its corporate subsidiaries, instituted this action pursuant to "An Act in relation to the payment and disposition of moneys received by officers and employees of the State of Illinois by virtue of their office or employment" (Ill. Rev. Stat. 1977, ch. 127, pars. 170 through 172a), seeking Illinois income tax refunds for the years 1973, 1974 and 1975. The disputed taxes were paid by the bank under protest, after it was notified by the Director of the Department of Revenue of the State of Illinois that an audit of its timely filed Illinois income tax returns indicated tax deficiencies for each of the years in question. The circuit court of Cook County entered judgment in favor of the bank. Specifically, the court found that the bank was entitled to a tax credit for the amortized portion of the premiums that the bank had paid to acquire certain State and municipal bonds. The State had refused to allow for amortization of the bond premium in computing net income for Illinois income tax purposes. (Ill. Rev. Stat. 1973, ch. 120, par. 2—203(b)(2)(A).) The

court also ruled that interest income from obligations issued by the United States government should be excluded from the apportionment formula outlined in section 304(c) of the Act (Ill. Rev. Stat. 1973, ch. 120, par. 3—304(c)). This formula is utilized to determine that portion of a financial institution's multistate business income which may be taxed by the State of Illinois. Finally, the court found that the bank was not subject to a penalty for underpayment of its estimated Illinois income tax for the first quarter of the taxable year ending December 31, 1975. Ill. Rev. Stat. 1975, ch. 120, pars. 8—801 through 8—804.

Defendants, the Department of Revenue of the State of Illinois, its director, and the Treasurer of the State of Illinois (collectively referred to as the State) appealed from the judgment of the circuit court. The appellate court reversed the trial court's findings on the amortization and penalty issues. The trial court's finding regarding the apportionment formula was affirmed. (115 Ill. App. 3d 538.) We granted the bank leave to appeal on the amortization issue. (No. 58876) The State's petition for leave to appeal on the apportionment issue (No. 58881) was also granted, and the causes have been consolidated for purposes of review. The Multistate Tax Commission was allowed to file an *amicus curiae* brief in support of the State's position on the apportionment issue. The Multistate Tax Commission is the official administrative agency of the Multistate Tax Compact entered into currently by 19 States and the District of Columbia as full members, and by 11 States as associate members.

The two issues before this court are: (1) whether premiums paid to acquire State and municipal bonds are properly included as "interest" subject to Illinois income tax pursuant to section 2—203(b)(2)(A) of the Illinois Income Tax Act (Ill. Rev. Stat. 1973, ch. 120, par. 2—203(b)(2)(A));

and (2) whether interest income, received on United States obligations, should be included in the apportionment formula used to determine the percentage of a financial organization's multistate business income subject to taxation by the State of Illinois. Ill. Rev. Stat. 1973, ch. 120, par. 3—304(c)(3).

Amortization of Bond Premiums

The bank is the owner of State and municipal bonds. While the interest from these bonds is exempt from Federal taxation, the corporate taxpayer is required to include this interest when computing his base income for Illinois tax purposes. (Ill. Rev. Stat. 1973, ch. 120, par. 2—203(b)(2)(A).) Thus, under the Act, a corporation's base income will include its Federal taxable income with certain modifications, including the addition of "[a]n amount equal to all amounts paid or accrued to the taxpayer as *interest* during the taxable year to the extent excluded from [Federal] gross income in the computation of taxable income." (Emphasis added.) Ill. Rev. Stat. 1973, ch. 120, par. 2—203(b)(2)(A).

At issue is the meaning of the term "interest" emphasized in the section of the Act quoted above. The bank maintains that the interest received on State and municipal bonds purchased at a premium (an amount exceeding the face value of the bond) should be adjusted when computing net income for Illinois income tax purposes. The bank points out that it will only recover the face value of the bond at maturity. In addition, under the Act, the bank cannot recognize a loss upon redemption or disposition of the bond. As such, when computing its base income for the years in dispute, the bank excluded, from the interest payments received on the bonds, an amortized portion of the premium paid to acquire the bonds.

In support of its position, the bank sets forth several arguments. Initially, the bank maintains that failure to recognize bond-premium amortization when computing base income violates the object of the Illinois Income Tax Act (Ill. Rev. Stat. 1973, ch. 120, par. 1—101 *et seq.*). The Act imposes a tax measured by "net income," not by capital. (Ill. Rev. Stat. 1973, ch. 120, par. 2—201(a).) To illustrate its position, the bank sets forth the following example. The bank purchases a $100 municipal bond for $105, with a stated interest of 5% per year. The bond is redeemable in 10 years for $100. Each year the bank would realize a $5 payment on the bond. The bank asserts that only $4.50 per year should be recognized as interest income for Illinois income tax purposes. It would reduce the $5 payment by $.50 each year for 10 years and thus recoup the premium paid to acquire the bond.

The State contends that the entire $5 payment must be reported as interest income each year. The State argues that the clear language of section 2—203(b)(2)(A) of the Act requires that the taxpayer add *all interest* payments excluded from his Federal gross income back into his Illinois base income. Since State and municipal bonds are exempt from Federal taxation and the Illinois Act authorizes no deductions for amortized premiums, it follows that the entire amount of interest payment is properly included in the computation of base income.

The bank contends that interest income earned on federally exempt bonds should be taxed in the same manner as federally taxable bonds. Section 171(a)(1) of the Internal Revenue Code of 1954, as amended (the Code), allows a deduction for the amortizable bond premium on a federally taxable bond. (26 U.S.C. sec. 171 (1976).) Thus, if the bonds at issue in this case had been subject to Federal taxation, the bank would have been allowed to adjust the interest received on the bonds to reflect the amortized pre-

mium. As such, the bank would only have been responsible, for Federal tax purposes, for the interest, less the amortized premium. Since a corporation's base income, under the Act, will include its Federal taxable income, only that portion of the interest would, in turn, have been subject to the Illinois income tax. If the State's position is followed, federally exempt bonds purchased at a premium will be taxed at a higher rate for Illinois income tax purposes than bonds purchased at a premium which are not federally exempt.

Directly related to this argument is the bank's argument that this disparate tax treatment violates the due process and equal protection clause of the fourteenth amendment to the United States Constitution (U.S. Const., amend. XIV) and the due process and equal protection and the uniformity provisions of the Illinois Constitution of 1970 (Ill. Const. 1970, art. I, sec. 2; art. IX, sec. 2).

It is undisputed that the legislature has broad powers to establish reasonable classifications in defining subjects of taxation. (*Thorpe v. Mahin* (1969), 43 Ill. 2d 36, 45; *Fiorito v. Jones* (1968), 39 Ill. 2d 531, 535.) Classifications, however, "must be based upon real and substantial differences between persons taxed and those not taxed [citation], and they must bear some reasonable relationship to the object of the legislation [citation], or to public policy [citation]." (39 Ill. 2d 531, 535-36.) It is the bank's position that according different treatment to bondholders of federally taxable bonds than to bondholders of federally exempt bonds bears no relationship to the object or policy of the Illinois Income Tax Act, which is to impose a tax measured by the taxpayer's net income. Ill. Rev. Stat. 1973, ch. 120, par. 2—201.

The State's only response to the bank's claim of unconstitutional discrimination is that it contributes to the "simple design of the Act." The State acknowledges that the

Act uses Federal taxable income as the starting point for corporate taxpayers, while providing a few addition and subtraction modifications. It goes on to say that the General Assembly chose not to enact many other additions, deductions, alterations or modifications in keeping with the design of the Act. The State concludes by stating that "[t]his is the reason why federally-exempt bonds are taxed the way they are, and this is not unreasonable."

Our resolution of this issue must be consistent with the general purpose of the Act to impose a tax measured by net income (Ill. Rev. Stat. 1973, ch. 120, par. 2—201). The Supreme Court has acknowledged that income received on a bond purchased at a premium will be less than the total receipts realized therefrom. Thus, in *Hanover Bank v. Commissioner* (1962), 369 U.S. 672, 677, 8 L. Ed. 2d 187, 191, 82 S. Ct. 1080, 1083-84, the court stated:

> "Bond premium is the amount a purchaser pays in buying a bond that exceeds the face or call value of the bond. When a bond sells at a premium, it is generally because the interest it bears exceeds the rate of return on similar securities in the current market. For the right to receive this higher interest rate the purchaser of a bond pays a premium price when making the investment. However, interest is taxable to the recipient, and when a premium has been paid the actual interest received is not a true reflection of the bond's yield, but represents in part a return of the premium paid. It was to give effect to this principle that Congress in 1942 enacted Section 125 [predecessor of section 171] of the 1939 Code, which for the first time provided for amortization of bond premium for tax purposes."

Section 125 of the 1939 Code was explained by the court in *Commissioner v. Korell* (1950), 339 U.S. 619, 621, 94 L. Ed. 1108, 1110, 70 S. Ct. 905, 906, as follows:

> "Prior to 1942, bond premium was irrelevant for tax purposes. Whether or not the purchase price exceeded

the face value of the bond, the holder considered the full price as the basis for capital gain or loss, and reported all taxable interest received as income. In presenting its 1942 tax proposals, however, the Treasury adopted the view that each receipt of interest is not entirely income but is partially a restoration of capital. Its spokesman pointed to the consequent discrimination against holders of taxable bonds: they were being taxed on a return of capital, while holders of tax-exempt bonds were not. To remedy this inequity, the Treasury recommended that amortization of premium be permitted in the case of taxable bonds, and that the basis for capital gain or loss for all bonds be adjusted by the amount of deduction allowable for taxables and disallowable for tax-exempts. These recommendations were ultimately included in the Revenue Act of [Oct 21] 1942, 56 Stat 798, 822, as sections 113 and 125 of the Internal Revenue Code."

While section 203(b)(2)(A) requires that amounts "paid or accrued to the taxpayer as interest" be added in computing base income, we find that the bank correctly modified the amounts received on the bonds to reflect the amortized premiums. Had the taxpayer included the amortized premiums, they would have been subject to a tax measured by capital, rather than net income. This is clearly in violation of the Act's goal of imposing a tax measured by net income.

Further, we point out that "there is a presumption favoring the constitutional validity of a State's scheme of taxation, 'and this presumption "may be overcome only by a clear showing that it is arbitrary and unsupportable by any set of facts." ' [Citations.]" (*Continental Illinois National Bank & Trust v. Zagel* (1979), 78 Ill. 2d 387, 409.) If we were to adopt the view favored by the State, we would have to conclude that section 2—203(b)(2)(A) of the Act is unconstitutional. It is arbitrary and unreasonable to discriminate by according different treatment to federally ex-

empt bonds than to federally taxable bonds. The differing treatment bears no relationship to the object of the Illinois Income Tax Act to impose a tax measured by net income. The State's argument for simplified administration and enforcement of the Act does not persuade.

Finally, we note that "[a] statutory amendment, presumptively indicative of an intent to change the law, does not conclusively establish that the legislature intended such a change [citation], and the presumption that a change was intended may be ' "*** overcome by more persuasive considerations" ' [citations]." (*Potts v. Industrial Com.* (1980), 83 Ill. 2d 48, 51.) The State maintains that House Bill 1400 (Pub. Act 83—561) is evidence of a legislative intent to change section 2—203(b)(2)(A) and is supportive of the State's construction of the law as it existed prior to the adoption of this bill.

House Bill 1400 was passed by the General Assembly in June 1983 and signed by the Governor on September 17, 1983, and is now contained in the Act as section 2—203(b)(2)(H). It allows the taxpayer to deduct "[a]n amount equal to the sum of all amounts disallowed as deductions by Sections 171(a), (2), and 265(2) of the Internal Revenue Code of 1954, as now or hereafter amended, and all amounts of expenses allocable to interest and disallowed as deductions by Section 265(1) of the Internal Revenue Code of 1954, as now or hereafter amended." (Ill. Rev. Stat. 1983, ch. 120, par. 2—203(b)(2)(H).) Since section 171(a)(2) of the Code disallows the deduction of the amortized portion of interest paid on State and municipal bonds (because they are federally tax-exempt), the new section 2—203(b)(2)(H) makes it clear that the taxpayer *can* deduct these amounts on its Illinois tax returns after adding the interest received on State and municipal bonds as per section 2—203(b)(2)(A). Accordingly, we find that in adopting

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House Bill 1400 (Ill. Rev. Stat. 1983, ch. 120, par. 2—203(b)(2)(H)), the legislature intended to clarify, rather than change, the existing law. We note that the June 25, 1983, debate in the Illinois Senate on House Bill 1400, while not determinative, supports our conclusion that House Bill 1400 is a clarification of existing law. During that debate, Senator George Sangmeister stated several times that this bill is a clarification of the principle of law that the same treatment should be given to municipal bonds as is given to corporate bonds issued at a premium.

It is true that "[w]ithout an express statutory provision stating an act is to have retroactive effect, it can only be applied prospectively." (*Village of Wilsonville v. SCA Services, Inc.* (1981), 86 Ill. 2d 1, 18.) Because we find that House Bill 1400 merely clarified the existing law, this proposition of law has no bearing on our determination of this issue. We find that the bank was entitled to amortize the premiums that it had paid to acquire State, county and municipal securities for the 1973, 1974 and 1975 tax years. Therefore, the judgment of the appellate court on the amortization issue must be reversed.

Apportionment Formula

When a corporation derives income from both Illinois and one or more other States, it becomes necessary to apportion the percentage of its income which may be taxed by this State. Section 3—304(c) of the Act (Ill. Rev. Stat. 1973, ch. 120, par. 3—304(c)) sets forth the one-factor formula to be utilized by a financial organization when making this determination. It provides in relevant part:

> "(c) Financial organizations. Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State, and the denominator of which is its business in-

come from all sources. For the purposes of this subsection, the business income of a financial organization from sources within this State is the sum of:

* * *

(3) Interest and dividends received within this State; ***."

The apportionment formula, therefore, may be expressed as follows:

$$\frac{\text{Illinois Gross Receipts}}{\text{Gross Receipts from all States}} \times \text{Tax Base (Business Income)} \times 4\%^{*} = \text{Illinois income tax}$$

*(4% = corporate tax rate for the years in question)

Thus, if a bank involved in multistate business had Illinois gross receipts of $500 and gross receipts from "all States" totaling $1,000 and a taxable business income from all sources of $800, the formula would work as follows:

$$\frac{\$500}{\$1{,}000} \times \$800 \times 4\% = \$16$$

At issue is the interest received by the bank on obligations of the United States government. During the 1973, 1974 and 1975 tax years, the bank received interest of $43,145,641, $62,176,825 and $54,679,968, respectively, in Illinois, on such Federal obligations. The bank excluded that interest when calculating the numerator and denominator of its gross receipts factor. This interest was also deducted by the bank when it computed its tax base.

The State does not contest the deduction of such interest from the tax base, since it is clearly exempt from Illinois income tax. (31 U.S.C. sec. 742 (1969) (now codified as 31 U.S.C. sec. 3124 (1982))). The State, as well as the Multistate Tax Commission, takes the position, however, that this tax-exempt interest should be included in the numerator and denominator of its gross-receipts factor. Although 31 U.S.C., section 742, prohibits taxation, directly or indirectly, on interest earned on United States obliga-

tions, the State maintains that since such interest is not included in the tax base, it is not considered in the computation of a tax as prohibited by the Federal statute. Rather, the interest is only used to distribute the tax base among jurisdictions in proportion to the percentage of business activity conducted in that jurisdiction. The Multistate Tax Commission, in support of this position, argues that inclusion of the interest earned on United States obligations is necessary to ensure the "fundamental principle" established by the drafters of the Division of Income for Tax Purposes Act (see Ill. Rev. Stat. 1983, ch. 120, par. 3—301 *et seq.*). In *GTE Automatic Electric, Inc. v. Allphin* (1977), 68 Ill. 2d 326, this court stated that "[t]he purpose of the uniform act and article 3 of the Illinois act is to assure that 100% and no more or no less, of the business income of a corporation doing multistate business is taxed by the States having jurisdiction to tax it." 68 Ill. 2d 326, 335.

Under section 742 of title 31 of the United States Code (1976), "[a]ll stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes." In *Society for Savings v. Bowers* (1955), 349 U.S. 143, 144, 99 L. Ed. 950, 955, 75 S. Ct. 607, 608, Mr. Justice Harlan stated:

> "In 1829 this Court decided in *Weston v. City Council of Charleston* [27 U.S. (2 Pet.) 449, 7 L. Ed. 481], that obligations of the Federal Government are immune from state taxation. This rule, aimed at protecting the borrowing power of the United States from state encroachment,

> was derived from the 'Borrowing' and 'Supremacy' Clauses of the Constitution, and the constitutional doctrines announced in *McCulloch v. Maryland* [(1819), 17 U.S. 316 (4 Wheat.) 316, 4 L. Ed. 579.] It was subsequently embodied in a succession of federal statutes, the existing statute being R.S. section 3701, 31 U.S.C. section 742. The rule has been carried forward to embrace indirect taxation of such obligations through their inclusion in a tax imposed on all the property of a taxpayer."

Until 1959, 31 U.S.C. section 742 only provided that obligations of the United States were exempt from taxation by or under State, municipal or local authority. In 1959, Congress amended section 742 by adding the second sentence of the section, quoted above. This addition emphasized the absolute prohibition of any consideration of such obligations, either direct or indirect, in the computation of a State or local tax. By including the interest received on United States obligations in the apportionment formula, the State, in this case, would do indirectly that which it is prohibited from doing directly. See *Federal Products Corp. v. Norberg* (R.I. 1981), 429 A.2d 447; *First Federal Savings & Loan Association v. Department of Revenue* (Mont. 1982), 654 P.2d 496, *cert. denied* (1983), ____ U.S. ____, 77 L. Ed. 2d 1378, 103 S. Ct. 3128.

In *American Bank & Trust Co. v. Dallas County* (1983), 463 U.S. ____, 77 L. Ed. 2d 1072, 103 S. Ct. 3369, the court considered a State bank-shares tax based on an equity-capital formula. The formula computed the tax on the basis of the difference between a bank's capital assets and liabilities. The court held that the tax was violative of section 742 because "such a tax takes into account, at least indirectly, the federal obligations that constitute a part of the bank's assets." (463 U.S. ____, ____, 77 L. Ed. 2d 1072, 1079, 103 S. Ct. 3369, 3374.) In a strongly worded opinion, the court emphasized that 31 U.S.C. section 742,

"as amended in 1959, is sweeping[,] *** 'extend[ing] to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation* of the tax.' " (Emphasis in original.) (463 U.S. ____, ____, 77 L. Ed. 2d 1072, 1078, 103 S. Ct. 3369, 3374.) Further, "[u]nder the plain language of the 1959 amendment, *** the tax is barred regardless of its *form* if federal obligations must be considered, either directly or indirectly, in *computing* the tax." (Emphasis in original.) 463 U.S. ____, ____, 77 L. Ed. 2d 1072, 1079, 103 S. Ct. 3369, 3374.

Including tax-exempt interest on United States obligations in the apportionment formula outlined in section 304(c) of the Act results in the indirect (at a minimum) consideration of a Federal obligation in the computation of a State tax. It is impossible to reconcile this approach, as taken by the State and the Multistate Tax Commission, with the express prohibition of 31 U.S.C. section 742 (1976) and the illuminating interpretation of section 742 opined in *American Bank & Trust Co.* We do find that it is possible to apply the section 304(c) apportionment formula without running afoul of the supremacy clause of the United States Constitution (art. VI, cl. 2) as well as article I, section 8, which provides Congress with the power "[t]o borrow money on the credit of the United States." U.S. Const., art. I, sec. 8, cl. 2.

Section 304(c)(3) of the Act (Ill. Rev. Stat. 1973, ch. 120, par. 3—304(c)(3)) instructs the taxpayers to include "[i]nterest and dividends received within this State" in the apportionment formula. The State maintains that the clear language of this provision mandates the inclusion of tax-exempt, as well as taxable, interest received within Illinois. We do not agree. "The purpose of the apportionment formula is to confine the taxation of business income to that

portion which is attributable to activities in Illinois." (*Caterpillar Tractor Co. v. Lenckos* (1981), 84 Ill. 2d 102, 123, *appeal dismissed sub nom, Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.* (1983), ____ U.S. ____, 77 L. Ed. 2d 1402, 103 S. Ct. 3562.) It is illogical to assume that the General Assembly would devise a formula to measure taxable income which includes income that is clearly tax-exempt.

We conclude, therefore, on the basis of the relevant Federal statute (31 U.S.C. sec. 742 (1969)) and the recent decision of the Supreme Court in *American Bank & Trust Co. v. Dallas County* (1983), 463 U.S. ____, 77 L. Ed. 2d 1072, 103 S. Ct. 3369, that tax-exempt interest income on obligations of the United States may not be taken into consideration in apportioning taxable income. As such, the judgment of the appellate court on the apportionment issue is affirmed.

The judgment of the circuit court of Cook County is affirmed as to the amortization and apportionment issues. Also, since the bank has not challenged the appellate court's reversal of the circuit court as to the penalty issue, the appellate court is affirmed in that regard and the circuit court is reversed.

Appellate court affirmed in part and reversed in part; circuit court affirmed in part and reversed in part.

APPENDIX B

IN THE
APPELLATE COURT OF ILLINOIS
FIRST DISTRICT

Filed May 31, 1983

81-962

Continental Illinois National Bank and Trust Company of Chicago; Continental Illinois Corporation; Continental Illinois Leasing Corporation; Marina City Building Corporation; Cobak Corporation; Continental Illinois (Delaware) Limited; Continental Illinois Overseas Service Corporation; and Continental Illinois Service Corporation,

Plaintiffs-Appellees,

vs.

Daniel J. Lenckos, as Acting Director of the Illinois Department of Revenue; Donald R. Smith, as Treasurer of the State of Illinois; and The Department of Revenue, State of Illinois,

Defendants-Appellants.

Appeal from the Circuit Court of Cook County.

Honorable
Joseph Wosik,
Judge Presiding.

JUSTICE CAMPBELL delivered the opinion of the court:

Plaintiffs, Continental Illinois National Bank and Trust Company of Chicago (hereinafter "the bank", a corporation, and seven subsidiary corporations, Continental Illinois Corporation, Continental Illinois Leasing Corporation, Marina City Building Corporation, Cobak Corporation, Continental Illinois (Delaware) Limited, Continental Illinois Overseas Service Corporation, and Continental Illinois Service Corporation, brought this action seeking income tax refunds. The taxes were paid by the Bank under protest pursuant to Ill. Rev. Stat. 1977, ch. 127.

par. 170-172a, and held in a protest account pending the final disposition of the case. Defendants are the Department of Revenue of the State of Illinois, the Director of Revenue of the Department of Revenue of the State of Illinois, and the Treasurer of the State of Illinois. Defendants have appealed from the judgment entered in favor of plaintiffs on January 13, 1981, and the order of March 20, 1981, denying the motion for reconsideration of said judgment. The Multistate Tax Commission[1], with leave of court, was allowed to file an amicus curiae brief.

The issues presented for review are as follows: (1) Whether apportionment of multistate business income to Illinois shall include interest received on United States obligations, which interest is exempt from Illinois income tax, in applying the apportionment formula prescribed in section 304(c) of the Illinois Income Tax Act (Ill. Rev. Stat. 1977, ch. 120, par. 3-304(c); (2) Whether all amounts paid or accrued to the taxpayer as interest on State and municipal bonds during the taxable year to the extent excluded from [U.S.] gross income, must be included in Illinois income; and (3) Whether underpayment of estimated income taxes, without correction by the final assessment date, requires an underpayment penalty.

The trial court ruled that the following amounts were assessed wrongly and improperly and contrary to law:

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[1] The Multistate Tax Commission (the Commission) is the official administrative agency of the Multistate Tax Compact (the Compact) entered into currently by 19 states and the District of Columbia as full members, and by 11 states as associate members. See, C. Bowsher, Comptroller General, "Report to the Chairman, House Committee on Ways and Means; Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving," (General Accounting Office, United States Government, 1982); *GTE Automatic Electric, Inc. v. Allphin* (1977), 68 Ill. 2d 326, 335, 369 N.E.2d 841, 845.

Issue	TAXABLE YEAR 1973	1974	1975
Apportionment (#1)	$12,175	$22,714	$60,694
Amortization (#2)	48,611	17,749	49,394
Penalty (#3)	—	—	48,132

and held that plaintiff was entitled to a credit for those monies paid under protest for the taxable year in question.

I.

The first issue presents a question of first impression in Illinois and relates to whether under the provisions of article 3 of the Illinois Income Tax Act (Ill. Rev. Stat. 1977, ch. 120, par. 3-301, *et seq.*) the numerator and denominator of the apportionment factor of plaintiff for the years 1973, 1974 and 1975 properly should include the amount of plaintiff's interest income for such years from United States government obligations, even though such interest income was exempt from the Illinois income tax.

Apportionment Formula

Whenever a corporation conducts business in more than one state, a question arises as to how much business income is earned in each of the states where business is transacted. Under the apportionment method, a one, two, or three factor formula is commonly used to determine the percentage of a corporation's business actually conducted within the State. This percentage is multiplied by the corporation's total taxable business income (tax base) in order to determine the portion of taxable income earned within the State. (Ill. Rev. Stat. 1979, ch. 120, par. 3-304.) Apportionment does not increase or

decrease the tax base (total taxable income); it determines what portion of that income was earned in each of the states in which a taxpayer transacts business. A corporation's tax base remains constant. "The purpose of the uniform act and article 3 of the Illinois Act is to assure that 100%, and no more or no less of the business income of a corporation doing multi-state business is taxed by the states having jurisdiction to tax it." *GTE Automatic Electric, Inc. v. Allphin* (1977), 68 Ill. 2d 326, 335, 369 N.E.2d 841, 845.

In *Caterpillar Tractor Co.* v. *Lenckos* (1981), 84 Ill. 2d 102, 106-7, 417 N. E. 2d 1343, 1346, the Supreme Court stated:

> "Under section 304(a), the Director of Revenue (Director) applies a three-factor (sales, payroll and property) apportionment formula which separately compares the total value of a corporation's in-State and out-of-State sales, payroll, and property, both tangible and intangible, with the total value of the corporation's in-State sales, payroll, and property alone. To illustrate: if the total multistate sales of a corporation are $10 million and its total Illinois sales are $1 million, the Illinois sales would represent one-tenth of the total multistate sales of the corporation, giving a sales factor of 10%. Once the percentage of the other factors, payroll and property is calculated, the three factors are averaged. This average is then multiplied by the total amount of business income generated by the corporation's in-State and out-of-State operations. If, for example, the sales, payroll and property multistate factors of the corporation are each 10% and its combined business income is $20 million, the amount of business income attributable to Illinois is $2 million."

Article 3 of the Illinois Income Tax Act, which provides for the three factor formula for the allocation and apportionment of the income of a corporation doing multistate business, contains the language of the Uniform Division of Income for Tax Purposes Act, (*GTE Automatic Electric v. Allphin* (1977), 68 Ill. 2d 326, 369 N.E.2d 841), and the customary 3-factor formula is utilized by most states to measure in-state business activity as follows:

$$\frac{\text{In-State Property}}{\text{Everywhere Property}} + \frac{\text{In-State Payroll}}{\text{Everywhere Payroll}} + \frac{\text{In-State Sales}}{\text{Everywhere Sales}}$$

equals Percentage of business activity conducted In-State

Section 304(c) provides as follows:

> "Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State, and the denominator of which is its business income for all sources. For the purposes of this subsection, the business income of a financial organization from sources within this State is the sum of: * * * (3) interest and dividends received within this State * * * (Ill. Rev. Stat. 1977, ch 120, par 3-304(c).)

However, in Illinois the General Assembly chose to use a one factor formula measuring the business activity of banks, as follows:

$$\frac{\text{Illinois Gross Receipts}}{\text{Gross Receipts From Everywhere}} \text{ equals } \text{Percentage of business Activity conducted in Illinois}$$

During the taxable years here involved the bank received in Illinois the following amounts as interest on obligations of the United States Government.

Year	Amount
1973	$43,145,641
1974	62,176,825
1975	54,679,968

The Director of Revenue concedes that such amounts of interest were exempt from the Illinois income tax. See *Willcuts v. Bunn* (1931), 282 U.S. 216, 51 S.Ct. 125, 75 L.Ed. 304. The

issue before this court is whether such interest, which is wholly exempt from Illinois income tax, may be taken into account in applying the one factor apportionment formula.

The Director argues that Illinois uses a one-factor apportionment formula to determine the amount of a financial organization's income which is subject to tax in Illinois and that the statute requires all interest received to be included in the measure of business activity. Interest received within this state is included in the numerator of the one-factor formula and the denominator includes interest from all sources. The language of the statute is clear and unambiguous and it is not in need of interpretation. The statute clearly provides that these sums must be included in the numerator and denominator of the apportionment formula.

The Director claims that the Department of Revenue is not seeking to tax interest as such which is exempt. If the intent of the statute was to exclude tax-exempt interest from the apportionment formula, the statute could have been limited to taxable interest received in this state, or the statute could have allowed a deduction for tax exempt interest similar to the deduction in Ill. Rev. Stat. 1977, ch. 120, par. 2-203(b)(2). The statute is not so limited in either of these ways.

The bank has countered with the observation that "there is no specific reference in the Act to the fact that interest on United States obligations is exempt from the Illinois income tax." The bank argues that section 203(b)(2) of the Act simply exempts "all amounts * * * which are exempt from taxation by this State either by reason of its Constitution or by reason of the Constitution, treaties or statutes of the United States." Ill. Rev Stat. 1977, ch. 120, par. 2-203(b)(2)(H). The exemption from Illinois income taxation of interest on United States obligations is derived not from the Illinois Income Tax Act but from federal law and the United States Constitution. Since there is no specific reference anywhere in the Act to such tax-exempt

interest, it can hardly be expected that the General Assembly would have thought it necessary specifically to exclude such tax exempt interest from the section 304(c) apportionment formula. Accordingly, the failure of the section 304(c) definition specifically to exclude tax-exempt interest on United States obligations does not provide a basis for the Department's contention that such interest was meant to be included.

In examining the legislative intent the bank asserts that interest on U.S. obligations is wholly exempt from Illinois income tax and also barred under federal law. (31 U.S.C. sec. 742 (1959); *Miller v. Milwaukee* (1927), 272 U.S. 713, 47 S.Ct. 280; 71 L.Ed. 487.) Section 742 provides as follows:

> "Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes." (31 U.S.C. § 742 (1959)

The bank also asserts that such transactions are exempt and the Department's interpretation of the Income Tax Act contravenes the Supremacy Clause of the United States Constitution (Art. VI, cl. 2) and Article I, section 8, which provides Congress with the power "[t]o borrow Money on the credit of the United States." (U.S. Const., art I, § 8, cl. 2.)

We gather from the bank's argument that the application of the apportionment formula under section 304(c) results in a direct or indirect tax on exempt interest which is prohibited. Under this argument each item or transaction is identified and excluded from the in-state overall business activity for state income tax purposes.

In this connection, the Multistate Tax Commission in support of the Department has argued that unlike Illinois, most

states do not have a special apportionment formula for banks. The customary 3-factor formula, property, payroll and sales is utilized, to measure in-state business activity. If a bank, such as Continental, has a staff of personnel whose duties include acquiring, managing and profitably disposing of U.S. securities, it follows that their payroll, offices, desks, telephones and sales will be fully reflected in the property, payroll and sales apportionment formula. Should this staff of personnel work only in Illinois, none of the 3-factor formula states can apportion in those states any of the Illinois property, payroll or sales connected with the business activity relating to the securities. Then, if Illinois is also prevented from including any measure of such business activity by the bank, the bank would escape all measurement of that business activity contrary to the holding in *GTE Automatic Electric* v. *Allphin* (1977), 68 Ill. 2d 326, 369 N.E.2d 841.

We are not persuaded that the cases cited by the bank, (*Missouri v. Gehner* (1930), 281 U.S. 313, 50 S.Ct. 326, 74 L.Ed. 870; *Miller v. Milwaukee* (1927), 272 U.S. 713, 47 S.Ct. 280, 71 L.Ed. 487; *Gibbons v. Ogden* (1824), 22 U.S. (9 Wheat 186), support the position that through the use of the apportionment formula that the same results in a direct tax or indirect tax on particular items of income. Rather, the factors that are included in the apportionment formula need not be attributable to particular transactions or activities associated with the bank's business. When an item of income or transaction is included in the apportionment formula the item of income is no longer identifiable as a separate item or entity, but is intended to and does become a part of the completed computation of the entire in-state business income. Thereafter, the total formula is properly a reflection and measure of the overall in-state business activity in the state and we do not view this application of the formula as a tax on a particular transaction.

We may have been inclined to accept the arguments of the Department and the Multistate Tax Commission except for an

additional authority brought to our attention by the bank, after oral arguments had been completed. In *Federal Products Corp. v. Norberg* (Sup.Ct. R.I. 1981), 429 A. 2d 447, the taxpayer corporation had invested a substantial portion of its cash in common stock and in U.S. Treasury notes and bonds. Later the notes and bonds were sold and the taxpayer was assessed with a deficiency based upon the tax administrator's inclusion of the proceeds and the interest derived from these securities as "gross receipts" in the computation of the Business Corporation Tax. The tax administrator pointed out "that the proceeds and the interest derived from these obligations were not included in the total taxable income but were merely used to measure the amount of the net income subject to tax." (429 A. 2d at 448.) On appeal, the Rhode Island Supreme Court stated:

> "The fact that the administrator did not *directly* tax the proceeds and interest from the U.S. Treasury notes and bonds and common stock is not determinative, for it is clear that 31 U.S.C.A. § 742 prohibits an *indirect* tax on such items. Although the administrator contends that he included the proceeds from the sale of the federal obligations and the interest merely as a measure to determine the corporate income tax due Rhode Island, he somehow overlooks the fact that the amount of the tax assessed was increased by more than $11,000 by the inclusion of the tax-exempt obligations in the measure of the tax. The only reasonable conclusion to draw is that this was an indirect tax upon federal securities and, thus, invalid." 429 A. 2d at 449.

See also, *First Federal Savings and Loan Assoc. v. Department of Revenue* (1982), ____ Mont. ____, 654 P.2d 496. The *Federal Products Corp.* case involves the precise issue involved herein and we perceive no reason to depart from its reasoning and holding. (See, Comment, "Federal Immunity from State Taxation: A reassessment" (1978), 48 U.Chi. L. Rev. 695.) We agree with the argument that there has been a substantial erosion in the per se prohibition or absolute immunity of the federal immunity doctrine from *McCulloch v. Maryland* (1819),

17 U.S. (4 Wheat.) 316, 4 L.Ed. 579; see also *Washington v.* U.S. (Docket No. 81-969, March 29, 1983), ____ U.S. ____ (51 LW 4305), but such rejection should not be extended to the facts of the instant case where the subject of the tax is a natural and traditional source of federal revenue. It follows that the action of the Department of Revenue was improper and the judgment of the trial court was correct as to the above issue.

II.

The second issue also concerns an item of interest payments and the dispute relates to the treatment of premiums paid for State municipal bonds under the Illinois Income Tax Act. During each of the taxable years 1973, 1975 and 1976, the bank received interest on certain state and municipal bonds which was exempt from federal taxation and the bank claims in computing its net income for Illinois income tax purposes, it added back to its Federal taxable income for the years in question only the true interest portion of each such payment. The bank's position is that a portion of each periodic receipt of interest on bonds will in fact represent merely a return of capital invested to acquire the bond and does not amount to an attempt to create a deduction. The bank maintains that what is involved is merely the obligation to construe the word "interest" that is susceptible to a proper construction as meaning true interest. As a result of this construction, the bank, in computing its net income for Illinois income tax purposes, excluded the amortized bond premium from the interest payments when computing its base income. Generally, for Illinois income tax purposes, the bank must include the interest to determine its base income. Ill. Rev. Stat. 1977, ch. 120, par. 2-203(b)(2)(A).

The bank insists that the position of the Department of Revenue in this dispute results in an unconstitutional discrimination in the administration of the Act in violation of the Due Process and Equal Protection Clause of the Fourteenth

Amendment to the United States Constitution and the due process and equal protection clause and the uniformity provisions of the Illinois Constitution of 1970 (Ill. Const. 1970, art. I, § 2; art IX, § 2).

In its brief the bank does not question that under the Act interest received on federal exempt bonds is income which is taxable for Illinois' purposes. However, such interest was intended to be taxed in the same manner as interest on federally taxable bonds. The effect of the Department's position would be to tax federally exempt bonds purchased at a premium at a higher rate of Illinois income tax than bonds purchased at a premium which are not federally exempt.

The Department contends that the entire interest payment must be reported as interest income in accordance with Ill. Rev. Stat. 1977, ch. 120, par. 2-203(b)(2)(A) which provides:

> "An amount equal to all amounts paid or accrued to the taxpayer as interest during the taxable year to the extent excluded from gross income in the computation of taxable income [shall be added to Illinois income]."

Both parties admit that prior to the Revenue Act of 1942 there was no deduction under the Federal Income tax law for amortizable bond premiums. "Whether or not the purchase price exceeded the face value of the bond, the holder considered the full price as the basis for capital gain or loss, and reported all taxable interest received as income." *Commissioner v. Korell* (1950), 339 U.S. 619, 621, 70 S.Ct. 905, 94 L.Ed. 1108.

The Department claims that it is only because Congress authorized a deduction for the amortized bond premium charges that this item of expense is presently deductible. (26 U.S.C. sec. 171 (1976.) Thus, the amount of state and local bond interest exempted from federal tax and excluded from federal gross income is gross interest, not net. Where the legislature defines state and local bond interest as the amount of interest excluded from federal gross income (see section

203(b)(2)(A)), it also meant gross state and local interest, not net. If the legislature had intended net state and local interest to be added to Illinois income, it would be net of all expenses, not just the premium expenses. No such legislative intent can be gathered from the language in the Act.

The bank has cited *Hanover Bank v. Commissioner* (1962), 369 U.S. 672, 82 S.Ct. 1080, 8 L.Ed. 2d 187, for the proposition that the actual income earned on a bond purchased at a premium is less than the amount of the interest payment received. *Commissioner v. Korell* (1950), 339 U.S. 619, 70 S.Ct. 905, 94 L.Ed. 1108, was also cited suggesting that the view of the U.S. Treasury when the deduction for bond premium amortization was proposed in 1942, was that part of the interest on a bond purchased at a premium was a restoration of capital. The discussion of the legislative history in the *Korell* case did not suggest that Congress adopted this view and it appears that the Court did not decide whether the amortization of a bond premium represents a return of capital. However, an analysis of the language employed in *Old Colony R. Co. v. Commissioner* (1932), 284 U.S. 552, 560-1, 52 S.Ct. 211, 76 L.Ed. 484, suggests that it is not. The bank has offered other examples and arguments of discrimination in treatment involving bonds issued by private corporations and federally taxable bonds, but the facts of the instant case do not involve such bonds. That the two taxing statutes in question are not precisely identical does not deprive the bank of any constitutional right as claimed.

The statutory language of section 203(b)(2)(A) of the Act should now be reviewed to determine the effects on the basic proposition asserted by the bank that bond premiums should be amortized and excluded in computing the amount of interest income from state and municipal bonds. The Department has cited *Bodine Electric Co. v. Allphin* (1980), 81 Ill. 2d 502, 410 N.E.2d 828, for the proposition that the General Assembly has not enacted or authorized any purported recogni-

tion or treatment or exclusion for periodic amortization of bond premiums on state, local and municipal bonds. The bank has responded and claimed that the Department misunderstands the federal tax law and the bank's position. The bank maintains that section 171(a)(2) of the Internal Revenue Code does not permit a federal deduction for amortizable bond premiums on state and municipal bonds, and the bank is not trying to create a new deduction for amortizable bond premiums under the Act. Instead, the legislature has already decided in Section 203 (b)(2)(A) to modify taxable income by adding thereto "all amounts paid or accrued to the taxpayer as interest * * * to the extent excluded from gross income." The bank contends that the language of this modification must be construed in accordance with the legislative intent to impose a tax under the Act measured by the net income and not measured by a return of capital. Amortization of bond premiums is proper in computing the amount of interest.

One major obstacle to the bank approach is that the Illinois Income Tax Act, Section 203(b)(2)(A), by its terms does not appear to offer support for the position urged. We do not perceive any reason to construe the word "interest" any differently than we have in other sections of the Act. In sum, the plain language of the Act strongly suggests that there is no such exclusion, treatment, or allowance as claimed. The plain language is controlling unless a different legislative intent is apparent from the purpose and history of the Act. (*Bodine Electric Co. v. Allphin* (1980), 81 Ill. 2d 502, 410 N.E.2d 828; *Mitchell v. Mahin* (1972), 51 Ill. 2d 452, 283 N.E.2d 465, *cert. den.* 409 U.S. 982; *Thorpe v. Mahin* (1969), 43 Ill. 2d 36, 250 N.E.2d 633.) "The legislative intent should be sought primarily from the language used in the statute, and if such intent can be ascertained therefrom, it should prevail without resorting to other aids for construction." *Weiss Memorial Hospital v. Kroncke* (1957), 12 Ill. 2d 98, 105, 145 N.E.2d 71, 74. Under the plain meaning of the Act there is a complete lack of authority to permit the bank to restructure the transactions to

make the disputed premium appear as a return of capital as separate accounting items. (See *Old Colony R. Co. v. Commissioner.*) There is no basis in the record or statute to support the view or concept urged by the bank.

Both parties have called our attention to *Moline National Bank v. Department of Revenue* (1983), 111 Ill. App. 3d 1086, 444 N.E.2d 1164. This recent case holds that the taxpayer may exclude an amortized municipal or state bond premium from base income and that "[t]he amortized premium does not represent income or interest." It is a return of capital." (111 Ill. App. 3d at 1088, 444 N.E.2d at 1166.) In its opinion the court also stressed the application of generally accepted principles of accounting and standard accounting practices as controlling. We have given detailed thought and consideration to this opinion and we are compelled to respectfully differ and to reaffirm our views as expressed herein.

We do not perceive that the issue in this case is controlled by generally accepted principles of accounting or standard accounting practices or whether the parties may use said principles of accounting to abrogate the clear intention of the statute. It appears that a taxpayer is free to treat and adopt any method of accounting that is not contrary to law, but under the facts of this case said treatment or method of accounting to reflect a return of capital is not binding on the Department of Revenue. If the taxpayer feels that there is an inequity in the statute, the matter should be addressed to the attention of the legislature. It follows that the trial court erred in entering judgment for the plaintiffs on this issue.

III.

The final issue relates to Sections 801-803 of the Illinois Income Tax Act requiring taxpayers to declare and pay estimated tax in four equal installments. Section 804 of the Act imposes a penalty on taxpayers who fail to pay (or who underpay) any such quarterly installment. (Ill. Rev. Stat. 1977,

ch. 120, par. 8-804.) The bank paid $300,000 as its installment of estimated Illinois income tax for the first quarter of 1975, or one fourth of the $1,200,000 which the Bank estimated would be its total 1975 Illinois income tax liability. The estimate was based on the amount the bank believed would be its 1974 liability. A return subsequently filed by the bank for 1974 showed an Illinois income tax liability for 1974 of $1,263,100. An amended return for 1974 indicated a tax liability of $1,149,387.

The Department has claimed that when the 1974 figure of $1,263,100 was filed by the bank on the last day for filing, it became assessed, that is, locked in under Illinois for all future computation purposes. (Ill. Rev. Stat. 1977, ch. 120, par. 9-903.) The bank has not brought itself within any of the exceptions in section 804(d) and the underpayment penalty was proper.

The bank has in effect argued that the filing of an amended return relates back to the filing of the original estimated quarterly return for purposes of avoiding the underpayment penalty. The bank has not cited any authority for this novel concept and we reject said effort to avoid the clear and unambiguous language of the statute. Therefore, it follows that the statute is controlling and the action of the Department was proper.

The judgment of the circuit court is reversed, and the cause is remanded for further proceedings not inconsistent with this opinion.

Reversed and remanded.

McGLOON and O'CONNOR, Jr., JJ., concur.

APPENDIX C

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS COUNTY DEPARTMENT, CHANCERY DIVISION

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO, et al.,

Plaintiffs,

No. 78 CH 5048 v.

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, et al.,

Defendants.

JUDGMENT ORDER AND DECREE

This cause coming on for a hearing pursuant to the Order of this Court dated August 14, 1980, which set the cause for hearing on November 3, 1980; the Court having read and considered the briefs and memoranda heretofore filed by the parties in support of their respective positions; the Court having considered the parties' oral arguments; and the Court being fully advised in the premises:

THE COURT HEREBY FINDS:

1. Plaintiff Continental Illinois National Bank and Trust Company of Chicago ("Continental Bank") is a corporation duly organized and existing under the laws of the United States.

2. Defendants are the Department of Revenue of the State of Illinois, the Director of Revenue of the Department of Revenue of the State of Illinois and the Treasurer of the State of Illinois.

3. This action has been properly brought pursuant to Ill. Rev. Stat. 1979, ch. 127, §§ 170-172a (the "Protest Act") to determine disposition of moneys paid by Continental Bank under protest and currently held by the defendant State Treasurer in a special fund (the "Protest Fund") pursuant to the Protest Act. The Court has jurisdiction of the parties and of the subject matter and venue is proper in this Court.

4. Continental Bank filed timely Illinois income tax returns for its taxable years ended December 31, 1973, December 31, 1974 and December 31, 1975 and filed timely amended returns (claims for refund) for the taxable years ended December 31, 1973 and December 31, 1974.

5. The Director of Revenue of the Department of Revenue of the State of Illinois ("Director") notified Continental Bank that an audit of its Illinois income tax returns (results of which were set forth in a notice dated April 28, 1978, commonly known as a 30-day letter) disclosed income tax deficiencies for each of the aforesaid years, and that additional amounts were payable as interest on such deficiencies.

6. On July 5, 1978 Continental Bank paid each alleged deficiency (and interest thereon), as set forth in plaintiffs' Second Amended Verified Complaint for Injunction, in full, and a portion or all of each payments was made under protest in accordance with the provisions of the Protest Act.

7. In computing the alleged deficiencies for the taxable years in question, the Department of Revenue took the following action:

(a) It increased the amount which Continental Bank reported as interest on state, county and municipal securities by $2,309,302 for the taxable year ended December 31, 1973; by $1,463,118 for the taxable year ended December 31, 1974; and by $1,666,098 for the taxable year ended December 31, 1975. Each amount represented amortized portions of the premiums that Continental Bank had paid to acquire those state, county and municipal securities.

(b) It increased the amount of Continental Bank's income apportioned to Illinois by increasing the numerator and the denominator of the apportionment factor of Continental Bank by $43,145,641 for the taxable year ended December 31, 1973; by $62,176,825 for the taxable year ended December 31, 1974; and by $54,679,968 for the taxable year ended December 31, 1975. Each amount represented interest income on United States Government obligations which interest income was exempt from the Illinois income tax under the provisions of Section 203(b)(2)(H) of the Illinois Income Tax Act [Ill. Rev. Stat. 1979, ch. 120, § 2-203(b)(2)(H)] and 31 U.S.C. § 742.

(c) It asserted that Continental Bank is liable for a penalty in the amount of $48,131.98 for underpayment of its estimated Illinois income tax for the first quarter of the taxable year ended December 31, 1975. Continental Bank computed and paid $300,000 (on or about April 15, 1975) as its estimated Illinois income tax payment for the first quarter of the taxable year ended December 31, 1975 on the basis that its 1974 Illinois income tax liability would be $1,200,000. Although Continental Bank's original Illinois income tax return for the taxable year ended December 31, 1974 (filed on or about July 15, 1975) showed an income tax liability of $1,263,100, its correct Illinois income tax liability for such year, as shown in its timely filed amended Illinois income tax return (claim for refund) for that year (filed on or about September 3, 1976), was $1,149,387.

8. On August 7, 1978 the Department of Revenue issued to Continental Bank a notice of deficiency (commonly known as a 45-day letter) covering income taxes for the years 1973, 1974 and 1975. In addition to the alleged income tax deficiencies as to which payments were made under protest on July 5, 1978, as set forth in paragraphs 5, 6 and 7 above, the 45-day letter asserted against Continental Bank additional deficiencies for each of those years.

9. On September 20, 1978 Continental Bank paid the additional alleged deficiency (and interest thereon) in full under protest in accordance with the Protest Act.

10. In computing the asserted additional income tax deficiency of Continental Bank described in paragraphs 8 and 9 above, the Department of Revenue disallowed the amount of $585,046 (representing amortized portions of premiums that Continental Bank had paid to acquire obligations of the United States) as a subtraction from federal taxable income in computing Illinois base income for the taxable year ended December 31, 1975. In its 30-day letter dated April 28, 1978, referred to in paragraph 5 above, the Department of Revenue had allowed such amount as a deduction. In contrast, in both its 30-day letter and its subsequent 45-day letter, the Department of Revenue allowed, as deductions, $706,091 for the taxable year ended December 31, 1973 and $871,438 for the taxable year ended December 31, 1974 (also representing amortized portions of premiums paid to acquire U.S. obligations).

11. Pursuant to the Protest Act, this Court entered a temporary restraining order on August 3, 1978 enjoining and restraining the defendants from transferring from the Protest Fund to any other fund, or otherwise disposing of, any moneys which plaintiffs had paid under protest

to the Department of Revenue. On August 16, 1978 this Court entered a preliminary injunction similarly enjoining and restraining defendants from transferring from the Protest Fund to any other fund, or otherwise disposing of, any moneys which plaintiffs had paid under protest to the Department of Revenue on July 5, 1978 or thereafter.

12. On August 14, 1980, pursuant to an Agreed Motion of all Parties to Bifurcate Issues of Law, this Court ordered that the non-unitary issues of law in this case be bifurcated from the mixed issues of law and fact concerning plaintiffs' unitary business status. The non-unitary issues were set for argument and hearing on November 3, 1980.

13. The foregoing findings relate to the non-unitary issues. This Court reserves for later determination all additional facts which relate to the unitary issues.

For the reasons stated in Plaintiffs' Memorandum of Law and Plaintiffs' Reply Memorandum of Law, THE COURT HEREBY RULES AND HOLDS:

1. Section 203(b)(2)(A) of the Illinois Income Tax Act (Ill. Rev. Stat. 1979, ch. 120, § 2-203(b)(2)(A)) requires the taxpayer to modify Illinois taxable income by adding to its federal taxable income an amount equal to all amounts paid or accrued to the taxpayer as interest during the taxable year to the extent excluded from Federal gross income in the computation of Federal taxable income. For the purposes of that section, "interest" means that portion of the amount received by the taxpayer which represents payment for the use or forbearance of money and not that portion which represents return of the taxpayer's capital. Continental Bank has demonstrated, with specific examples, that if the Illinois Department of Revenue's

position were adopted, the Department would tax as income an amount in excess of income actually earned through ownership of certain state, local and municipal bonds. A tax on more income than is earned would be an impermissible tax on capital. The word "interest" is susceptible to construction and this Court construes it in a way which it believes the Illinois legislature intended and which does not impose an income tax on capital. Accordingly, Continental Bank properly took into account amortized bond premiums in computing interest on state, local and municipal bonds and the Department of Revenue properly took into account amortized bond premiums in computing interest on U.S. government obligations to the extent that it did so in computing Continental Bank's income for the taxable year ended December 31, 1975. To the extent that amortized bond premiums on U.S. obligations were not taken into account in computing Continental Bank's interest deduction for the taxable years ended December 31, 1973 and December 31, 1974, the Court orders that such amortization be taken into account in determining the amount of refund due to Continental Bank. Accordingly, defendants' assertions summarized in finding 7(a), above, are without merit. However, defendants' assertion that the subtraction for U.S. government obligations should be net of amortized premiums for the taxable year ended December 31, 1975, as summarized in finding 10, above, is upheld and is extended to the taxable years ended December 31, 1973 and December 31, 1974.

2. Section 304(c) of the Illinois Income Tax Act provides that business income of a financial organization be apportioned based upon the ratio that its business income from sources in this State bears to its total business income. Included as business income from sources within this State is interest received within this State. This

Court holds that under the Illinois Income Tax Act the "interest" included in the apportionment factor is only that interest which the State of Illinois has the constitutional power to tax. The State of Illinois does not have the constitutional power to tax interest on obligations of the United States. The Court holds that income which cannot be taxed by the State of Illinois also cannot be included in a formula the purpose of which is to determine the amount of taxable income properly allocable to the State of Illinois. Accordingly, Continental Bank properly excluded from the apportionment formula all interest income from obligations of the United States in computing its Illinois income tax liability, and defendants' assertions which are summarized in finding 7(b), above, are without merit.

3. Sections 801-803 of the Income Tax Act require taxpayers to declare and pay estimated tax in four equal quarterly installments. (Ill. Rev. Stat. 1979, ch. 120, §§ 8-801—8-803). Section 804 of the Act imposes a penalty on taxpayers who fail to pay (or who underpay) any such quarterly installment. (Ill. Rev. Stat. 1979, ch. 120, § 804). However, Section 804(d)(1) provides that no penalty for underpayment will be imposed if the amount of each installment of estimated tax is at least one-fourth of the amount of tax shown on the taxpayer's return for the preceding taxable year. (Ill. Rev. Stat. 1979, ch. 120, § 8-804 (d)(1)). Continental Bank filed a timely amended Illinois income tax return (claim for refund) showing a tax liability of $1,149,387 for the year 1974. Continental Bank's payment for its first installment of its estimated Illinois income tax for the first quarter of 1975 was $300,000 and therefore exceeded one-fourth of the amount shown on the amended return. This Court finds that the timely amended return constitutes "the return of the taxpayer for the preceding taxable year" within the meaning of the statute

and, accordingly, Continental Bank is not subject to the penalty asserted by the Department of Revenue and defendants' assertions which are summarized in finding 7(c), above, are without merit.

4. Accordingly, the Court rules that the following amounts were assessed wrongly and improperly and contrary to law:

	Taxable Year		
Issue	1973	1974	1975
Amortization (¶ 1)	$48,611	$17,749	$49,394
Apportionment (¶ 2)	$12,175	$22,714	$60,694
Penalty (¶ 3)	---	---	$48,132

and that Continental Bank is entitled to a credit for those moneys which it paid under protest, in the amount set forth above, against its tax liability, for each of the taxable years at issue and to judgment therefore.

ACCORDINGLY, IT IS HEREBY ORDERED, ADJUDGED AND DECREED:

1. Judgment is hereby ordered in favor of Plaintiff Continental Bank and against Defendants Department of Revenue of the State of Illinois, the Director of Revenue of the State of Illinois, and the Treasurer of the State of Illinois, on the non-unitary claims as set forth in the Complaint.

2. The Court expressly rules pursuant to Illinois Supreme Court Rule 304(a) that there is no just reason for delaying enforcement or appeal of this Judgment Order and Decree.

ENTER: /s/ Joseph M. Wosik
Judge

DATED: January 12th, 1981

APPENDIX D

CORRECTED TITLE
(Correction issued July 10, 1984)

STATE OF ILLINOIS
SUPREME COURT

At a Term of the Supreme Court, begun and held in Springfield, on Monday, the fourteenth day of May, 1984.

Present: Howard C. Ryan, Chief Justice
Justice Robert C. Underwood
Justice Joseph H. Goldenhersh
Justice Thomas J. Moran
Justice Daniel P. Ward
Justice William G. Clark
Justice Seymour Simon

On the 25th day of May, 1984, the Supreme Court entered the following judgment:

Continental Illinois National Bank and Trust Company of Chicago, et al., *Appellants,*	)	
Nos. 58876 v. 58881 Cons.	)	Appeal from Appellate Court First District 81-962 78 CH 5048
Daniel J. Lenckos, as Acting Director of the Illinois Department of Revenue; et al., etc., *Appellees.*	)	

It is the judgment of this Court that the part of the judgment of the Appellate Court, First District, on the amortization issue is REVERSED; that part of the judgment on the apportionment issue is AFFIRMED. The judgment of the Circuit Court of Cook County is AFFIRMED as to the amortization and apportionment issues. The Appellate Court is AFFIRMED as to the penalty issue and the Circuit Court is REVERSED as to that issue.

Appellate Court affirmed in part and reversed in part; Circuit Court affirmed in part and reversed in part.

As Clerk of the Supreme Court of the State of Illinois and keeper of the records, files and Seal thereof, I certify that the foregoing is a true copy of the final order entered in this case.

IN WITNESS WHEREOF, I have hereunto subscribed my name and affixed the Seal of said Court this 29th day of June, 1984.

/s/ Juliann Hornyak
Clerk,
Supreme Court of the
State of Illinois